BELL TOWER ADVISORS

03/21/13: Where is Cyprus

Before all the news about Cyprus started hitting, I wasn't even sure how to pronounce the country, let alone exactly where it's located. In case anyone else has the same dilemma (ok, I am probably the only one), it is pronounced "Sipe-ress" and it is a tiny island in the Mediterranean south of Turkey, west of Israel, and farther southeast of Greece. The Republic of Cyprus, with a population of just over 1 million people (slightly more than the city of San Jose, CA) would seem an unlikely place to trigger a global financial crisis. It is divided by a U.N.-monitored buffer zone rather less hostile than the one in Korea, and the only news you generally hear is how Greece and Turkey both claim the island once used by Richard the Lionhearted as a staging ground for Crusader attacks on Jerusalem. Now, suddenly, news outlets are declaring that a failed bailout of this tiny nation could shatter the European Union's finances, sending financial shock waves around the world. Shares on European stock exchanges have plunged in panic selling, and it remains to be seen whether U.S.-based investors will join this fearful exodus. Meanwhile, the biggest potential losers in this crisis could be Russian mobsters.

What do we need to know about this latest Eurozone crisis? First, that it represents a display of incredibly poor timing. The southern part of the small nation gave up its currency (the Cyprus pound) for the Euro in January 2008, just before the global economic crisis hit. The meltdown was followed by a severe financial crisis in Greece--and, since most of the people living south of the U.N. buffer zone are ethnic Greek, it is not surprising that the country's banks would have had substantial holdings of Greek public and private debt.

The restructuring fell like a hammer on the Cyprus banking system. The Washington Post recently estimated that the nation's two largest lending institutions--Cyprus Popular Bank and the Bank of Cyprus--ended up losing $4.4 billion and $3.1 billion respectively on their Greek debt investments--roughly 76 percent of their value.

The reason you didn't read about any of this last year or the year before, during the bondholder-negotiated haircuts, is because the Cyprus government reached into its pocket and provided the necessary liquidity to its banking system--or, in the case of Popular Bank, simply took over the lending institution as a government subsidiary. Unlike its insolvent neighbor to the north (or, for that matter, the U.S.), the Cypriot government takes in more tax revenues than it spends. But when the nation's 10-year government borrowing rates rose from 4.5% to 7%, it became clear that a broader bailout would be necessary.

How much are we talking about? An estimated $12 billion would restore solvency. In negotiations with the European Central Bank and the International Monetary Fund, the Cypriot government agreed to a solution that is (so far) unique in the Eurozone: the government would assess a one-time tax on its country's bank depositors--taking 6.75% of all deposits of 100,000 Euros or less, and 9.9% on deposits greater than that amount. This would have raised $7 billion, more than half the needed total, and the IMF and ECB agreed to provide the rest of the cash in the form of loans.

Why the different tax rates? That's a story in itself. The Washington Post reports that Russian companies have been setting up subsidiaries in Cyprus as a way to evade Russia's heavy taxes on money they earn abroad. There are also reports that Russian tycoons have been using the Cypriot banking system to launder dirty money, and using Cyprus to evade U.N. restrictions on sending weapons to the Syrian government. German intelligence reports suggest that at least 20 billion Euros of the 70 billion Euros deposited in Cyprus's banking system were put there by Russian oligarchs.

Most of those Russian deposits, of course, exceed the 100,000 Euro threshold by a few orders of magnitude, and therefore would have been taxed at the highest rate. This explains what might otherwise be a puzzling part of the Cyprus default story: the fact that Cyprus's finance minister Michael Sarris flew to Russia instead of Belgium when the crisis became public, or that Russian President Vladimir Putin took time out of his workday to publicly pronounce the tax levy, in a very small country far from Russian shores, as "unprofessional and dangerous."

You've probably seen, in blaring headlines, reports that the Cyprus parliament ultimately rejected this plan to confiscate billions from the country's savers and foreign oligarchs, causing the rescue package to collapse and triggering yet another global hand-wringing over the fate of the Euro. But there are also reports that Russia has offered Cyprus a loan of $3 billion at favorable 4.5% interest rates, and indicated a willingness to sweeten the deal if necessary.

Should you be worried about all this? It depends on whether a big part of your investment portfolio is allocated to the Cyprus stock exchange, which suspended trading on Tuesday and Wednesday while the mess gets sorted out. (Answer: probably not.) If not, consider that Cyprus can always go back to its original currency as a last resort, without endangering the Euro banking system the way, say, a Greek or Spanish exit might. And also remember that Cyprus is in the habit of running a government surplus, which means that the country will eventually get back on its financial feet again--probably after the Russian oligarchs and their government have quietly refinanced their private tax haven.

Probably much more than you ever wanted to know about the mess in Cyprus, but at least going forward you'll know how to pronounce the name correctly.

Sources: http://www.washingtonpost.com/blogs/wonkblog/wp/2013/03/18/everything-you-need-to-know-about-the-cyprus-bailout-in-one-faq-2/

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